Fourth Quarter 2023

Powered by the so-called Magnificent Seven (M7), 2023 was a banner year for benchmark U.S. equity indices. The S&P 500 returned 26.3%, the Dow gained 16.2% and the NASDAQ jumped 44.9%-its best calendar year performance since 1999. After two painful years of losses driven by the Federal Reserve's aggressive rate hiking campaign to contain inflation, bonds also ended the year in the black. Higher coupon income from bonds issued in the last two years and a year-end rally (rates down/prices up) produced positive returns. In this quarter's edition of the Market Comments, we examine monetary policy and inflation, equities, fixed income, and the implications for risk and portfolio management going forward.

Inflation, monetary policy, and the "Fed Put"

The Federal Reserve's campaign to curb inflation made significant progress in 2023. The most recent reading of core Personal Consumption Expenditures (PCE) in November 2023 showed a 3.2% year over year increase, which is 140 basis points (30%) lower than six months ago. When annualized, the core PCE trend for the last six months appears to indicate that inflation is near the Fed's 2% target. In a pronounced shift from the "higher for longer" message delivered as recently as September, Fed Chairman Jerome Powell stated at his post meeting press conference on December 13th that the risk of keeping monetary policy in restrictive territory for too long was now on the Fed's radar: "you're getting now back to the point where both mandates are important and they are more in balance too," and, judging from the financial markets' reaction, reactivating the so-called Fed put. While the Fed's aggressive interest rate hiking campaign has (as intended) moderated economic growth, the Fed has managed, thus far, to achieve a moderation of growth and inflation without a corresponding jump in the unemployment rate. While the labor market remains tighter than the Fed would like, the participation rate for prime age workers has jumped to nearly a two-decade high and the number of job openings has come down, leading to a moderation in wage growth. This supply side-driven moderation in wage pressure is confirmed by survey data from the regional Federal Reserve banks that indicate that firms are much less acutely understaffed relative to 2020-2022.

While the slowdown in inflation is certainly a welcome development, and the resurrection of the Fed put is positive for risk assets, markets are currently pricing a perfectly soft landing for the economy and a smooth and hasty return of inflation to near the Fed's stated 2% target. However, both downside risks for growth and upside risks for inflation remain, potentially putting downward pressure on equity prices and upward pressure on bond yields. While the economy has proven more resilient to higher interest rates than anticipated, it appears that the U.S. consumer, the driver of U.S. and, to a meaningful degree, global growth is increasingly under pressure. Consumer spending growth has moderated to what would have been considered the high end of the range in the five years leading up to the Pandemic. Furthermore, the spending growth that persists is increasingly being done with borrowed money. Revolving credit balances are near an all-time high of ~$1.3 trillion and delinquency rates are rising. What's more, as Chairman Powell indicated in his December press conference, it is too early to declare victory in the inflation fight. A still tighter than comfortable labor market, an undersupplied housing market, and the potential for increased defense spending in response to geopolitical uncertainty are all potential catalysts for renewed inflationary pressure.

Equities

While the direction of travel in equity markets was up in 2023, it was in many respects a typically volatile year for equity investors. The S&P 500 came out of the gate strongly in 2023, gaining 9.3% by early February. As stresses in the banking system began to percolate to the surface, culminating in the failures of Silicon Valley Bank and Signature Bank, and J.P. Morgan's takeover of First Republic, the S&P 500 fell nearly 8%. Mid-March through the end of July saw equity markets rally, with the S&P 500 gaining 19% as the economy proved more resilient to higher interest rates than feared and investor enthusiasm for Artificial Intelligence (AI)-related stocks soared. From late July through the end of October the S&P 500 declined 10% as the Fed emphasized the "higher for longer" message and Treasury yields climbed. Early November through year end saw the S&P 500 stage a 17% rally as companies reported better than feared Q3 earnings, incoming inflation data continued to moderate, and the Fed put came back into play.

It is worth noting that the S&P 500's 2023 performance was bifurcated between the "haves" and the "have nots." The "haves," a.k.a. the M7 mega cap technology stocks (AAPL, AMZN, GOOG, META, MSFT, NVDA, TSLA), which collectively represent ~29% of the S&P 500's market capitalization were responsible for ~75% of the S&P 500's 2023 gain. The top two holdings in the S&P 500, AAPL and MSFT, currently represent ~15% of the market capitalization of the S&P 500 which is exceptionally concentrated relative to history. Near prior peaks in 1983 (IBM and T), 1999 (MSFT and GE), and 2008 (XOM and WMT) the two biggest stocks represented 10.9%, 9.1%, and 7.7% of the S&P 500's market capitalization, respectively. Apart from NVDA, the 2023 returns of the M7 were largely driven by multiple expansion. Assuming consensus EPS growth of ~26% for the group, the average forward P/E of the M7 is ~31x, which is elevated relative to the ~24-25x that has characterized the last decade. In contrast to the "haves," the "have nots" represented by the so-called S&P 493 experienced more modest gains in 2023. While imperfect, the equal-weight version of the S&P 500 (where the M7 represent 1.4% of the index) serves as a reasonable proxy for the S&P 493. It was up 13.9% in 2023, but also trades at a more reasonable ~16x 2024 earnings expectations.

The question for equity investors, as always, is: what is already in the price? In the case of the capitalization weighted S&P 500 (~19.5x expected 2024 earnings) and the M7, the answer appears to be a fair amount of good news. In contrast to its capitalization weighted counterpart the equal weight S&P 500 trades for ~16x estimated 2024 earnings, which compares favorably to an average of ~17x over the preceding decade.

So where does this leave equity investors? In short, the long-term prospects of AI are tremendous and the M7 are, on balance, businesses with wide moats, exceptionally strong balance sheets, and well positioned to profit from the commercialization of AI at scale. However, the commercial implementation of AI is in its early innings and investor expectations about the performance of the broader economy and execution by the M7 are very high and do not offer investors a significant margin of safety in our view. S&P 493 valuations do appear to offer investors a somewhat greater margin of safety. As mentioned above, our caution as it relates to the M7 is less about the long-term quality of the businesses and more about how much good news is already in the prices. All of that said, we continue to seek opportunities to take positions in companies that meet our criteria for balance sheet strength, free cash flow generation, competitive moats, and contextually reasonable valuations.

Fixed Income

After two consecutive years of losses in 2021 and 2022 courtesy of the Fed's rate hiking cycle, bond investors had a year of positive, though volatile, returns in 2023. Benchmark ten-year Treasuries opened 2023 at a 3.88% yield, before hitting a low point of 3.31% in early April. From there, ten-year yields ground steadily higher, as worries about the banking system receded and the Fed repeated its "higher for longer" mantra, with ten-year yields peaking at 4.99% in mid-October. Two-year Treasuries, which more closely track the expected path of Federal funds, opened 2023 with a yield of 4.43% and saw a low for the year of 3.77% in mid-March. Two-year yields peaked at 5.22% in mid-October before rallying into year end, finishing the year at 4.25%.

The bond market continues to give investors conflicting signals. On one hand, investment grade credit spreads were relatively low and stable throughout the year, and the spread between high yield and investment grade bonds was also well below average, suggesting that credit markets are not anticipating a significant slowing of the economy. On the other hand, the yield curve remains inverted, which has historically been an indicator of a recession on the horizon.

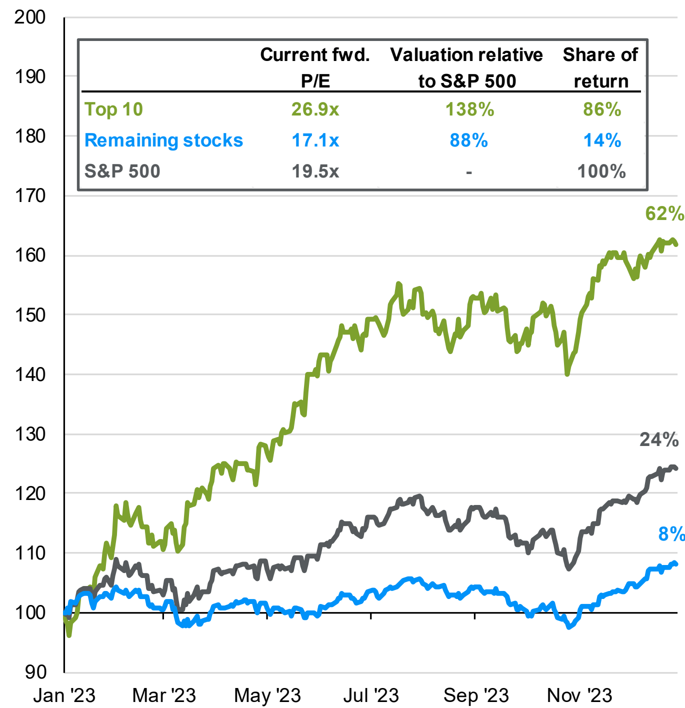
Rates have come down from the fall of 2023 peak, and high quality corporate and taxable municipal bonds are currently offering yields in the mid 4% to low 5% range while high quality tax-free municipals are currently carrying taxable equivalent yields in the low to mid 4% range. Fixed income continues to be an attractive option for income-focused investors provided that inflation does ultimately settle somewhere close to the Fed's stated 2% target. Furthermore, while the Fed's rate hiking cycle has been painful for bond investors, higher interest rates have brought the diversification benefits of bonds back into play in the event of an economic downturn. We continue to deploy our strategy of building laddered bond portfolios with final maturities of approximately 10-12 years and overall duration of 5-6 years, though the profile of individual portfolios can be tailored to meet specific client objectives. We have been adding to portfolios across the maturity spectrum, which allows investors to capture currently available yields while also being reasonably well hedged against interest rate risk. If rates move higher from here, bonds maturing in the near term can be reinvested at higher rates. Conversely, if rates come down and the yield curve assumes a more normal upward slope, investors have locked in reasonably attractive yields on high quality credits.

Summary

The aggressive interest rate hiking cycle initiated by the Federal Reserve in March 2022 has made a meaningful dent in inflation and has brought the Fed's dual mandate for full employment and stable prices closer to being in balance. Thus far, the economy has generally tolerated higher rates well, with wage pressure moderating without a corresponding spike in unemployment. Led by the M7, benchmark equity indices had a strong performance in 2023 and bond investors enjoyed a respite from two consecutive years of losses. Equity markets are bifurcated between the M7 and the S&P 493. The former carry elevated valuations that are pricing a soft-landing for the economy and strong company execution and offer a relatively smaller margin of safety. The latter have lagged the broader market but have valuations that offer upside potential if a soft-landing plays out and a greater margin of safety if the economy does enter a downturn. Bond markets continue to send mixed signals. On one hand credit spreads are not indicating future economic stress, while on the other hand the yield curve remains inverted which has historically been an indicator of a recession on the horizon. Though interest rates have come down from last fall's peak, current yields are relatively attractive compared to the last decade. Against this backdrop we continue to follow our time-tested research process in both equities and fixed income, with a focus on high quality companies and credits to help manage risk and provide downside protection in difficult markets. Over the long run we believe that equities will continue to be the driver of compounding returns in portfolios. However, given the uncertain environment, reasonable yields on high quality fixed income investments mean that bonds can play an important role in many portfolios as a means to generate income, provide predictable liquidity, and provide a degree of diversification. Of course, asset allocation and portfolio construction are driven by each client's specific time horizon, investment goals, liquidity needs, and risk tolerance. We welcome the opportunity to meet with clients to make sure these variables are aligned.

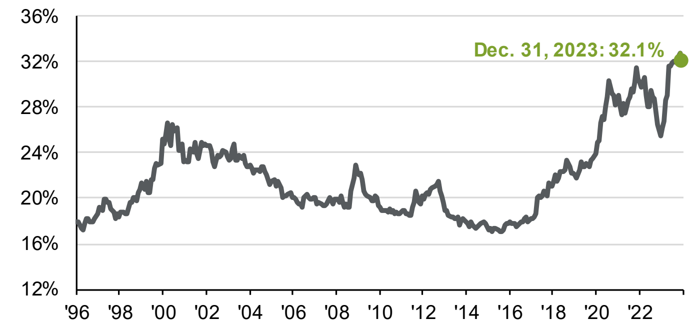
In 2023, portfolio diversification did not work

Performance of the top 10 stocks in the S&P 500
Indexed to 100 on 1/1/2023, price return, top 10 held constant

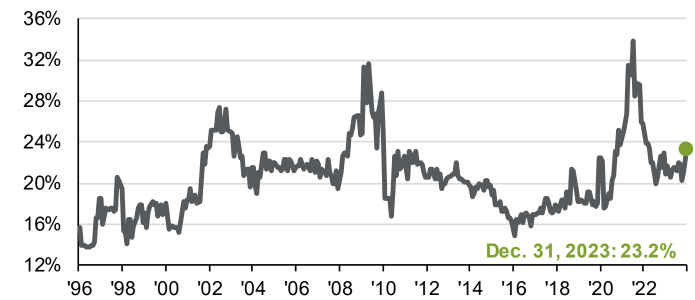


	Current fwd. P/E	Valuation relative to S&P 500	Share of return
Top 10	26.9x	138%	86%
Remaining stocks	17.1x	88%	14%
S&P 500	19.5x	-	100%

Weight of the top 10 stocks in the S&P 500
% of market capitalization of the S&P 500



Earnings contribution of the top 10 in the S&P 500
Based on last 12 months' earnings



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Evolution of the top ten holdings in the S&P 500 by year

2023	
Apple	7.0%
Microsoft	7.0%
Google	3.9%
Amazon	3.5%
Nvidia Corp	3.1%
Meta Platforms, Inc. Class A	2.0%
Tesla	1.7%
Berkshire Hathaway	1.6%
JP Morgan	1.2%
Broadcom	1.2%
Total	**32.1%**

2020	
Apple	4.8%
Microsoft	4.7%
Amazon	4.2%
Google	3.1%
Facebook	2.1%
Berkshire Hathaway	1.4%
Visa	1.3%
Johnson & Johnson	1.2%
Walmart	1.1%
JP Morgan	0.9%
Total	**24.8%**

2010	
Exxon	3.1%
Apple	2.5%
Microsoft	2.0%
Berkshire Hathaway	1.7%
General Electric	1.6%
Walmart	1.6%
Google	1.6%
Chevron	1.5%
IBM	1.5%
Proctor & Gamble	1.5%
Total	**18.6%**

2000	
General Electric	4.1%
Exxon	2.6%
Pfizer	2.5%
Citigroup	2.5%
Cisco	2.4%
Walmart	2.0%
Microsoft	2.0%
AIG	2.0%
Merck	1.9%
Intel	1.7%
Total	**23.7%**

1990	
IBM	3.0%
Exxon	2.9%
General Electric	2.3%
Phillip Morris	2.2%
Royal Dutch	1.9%
Bristol Myers	1.6%
Merck	1.6%
Walmart	1.6%
AT&T	1.5%
Coke	1.4%
Total	**20.0%**

1980	
IBM	4.3%
AT&T	3.9%
Exxon	3.8%
Standard Oil (IN)	2.5%
Schlumberger	2.4%
Shell Oil	1.9%
Mobil	1.9%
Standard Oil (CA)	1.8%
Atlantic Richfield	1.6%
General Electric	1.5%
Total	**25.6%**

After run-up in 2023, market is expensive

Valuation measure	Description	Latest	30-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	19.51x	16.59x	0.90
CAPE	Shiller's P/E	32.43x	27.55x	0.79
Div. Yield	Dividend yield	1.54%	2.00%	1.33
P/B	Price to book	3.97x	3.11x	1.10
P/CF	Price to cash flow	14.82x	11.13x	1.64
EY Spread	EY minus Baa yield	-0.33%	0.04%	0.20

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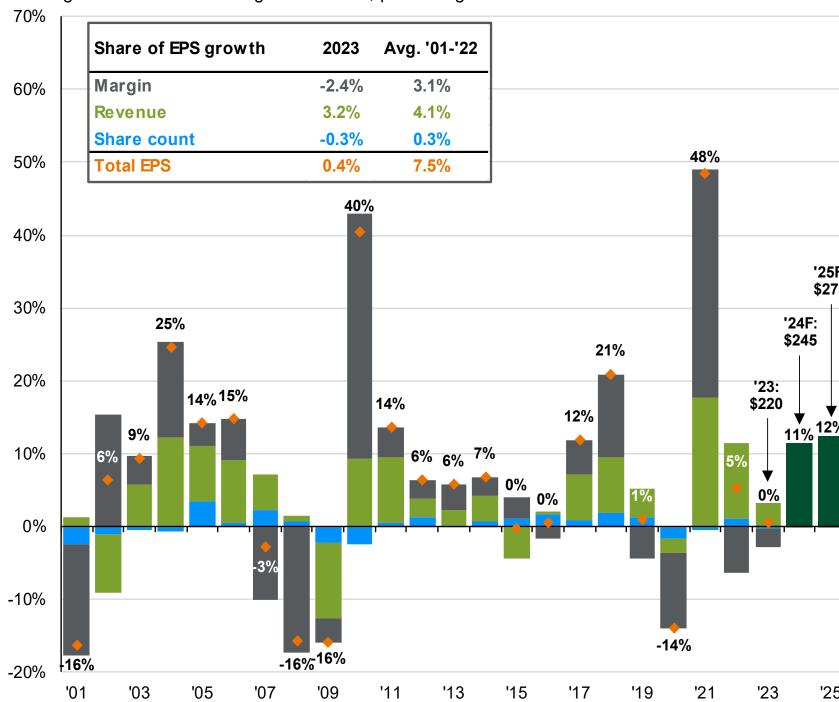
S&P 500 profit margins have declined from peak levels in 2021



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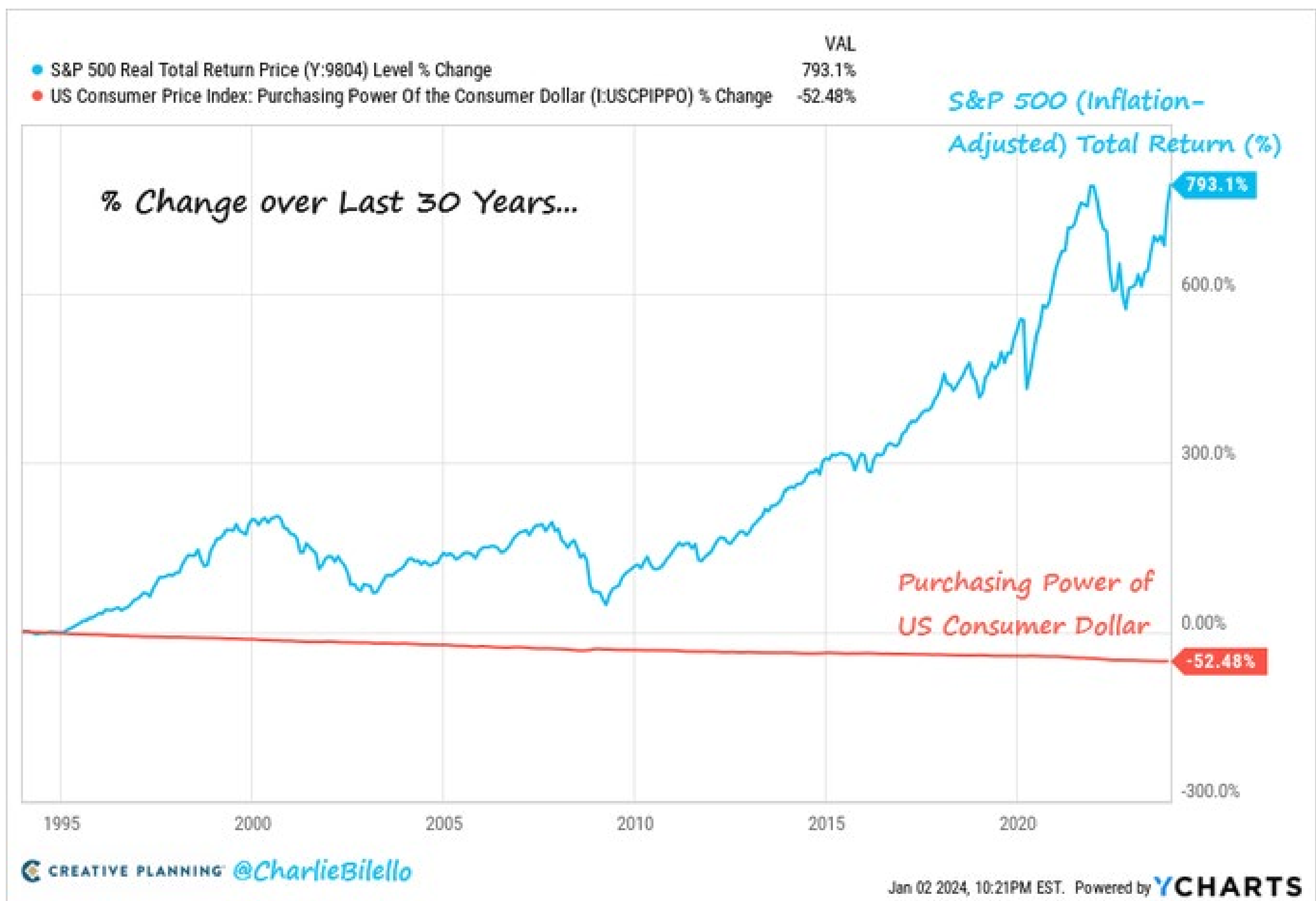
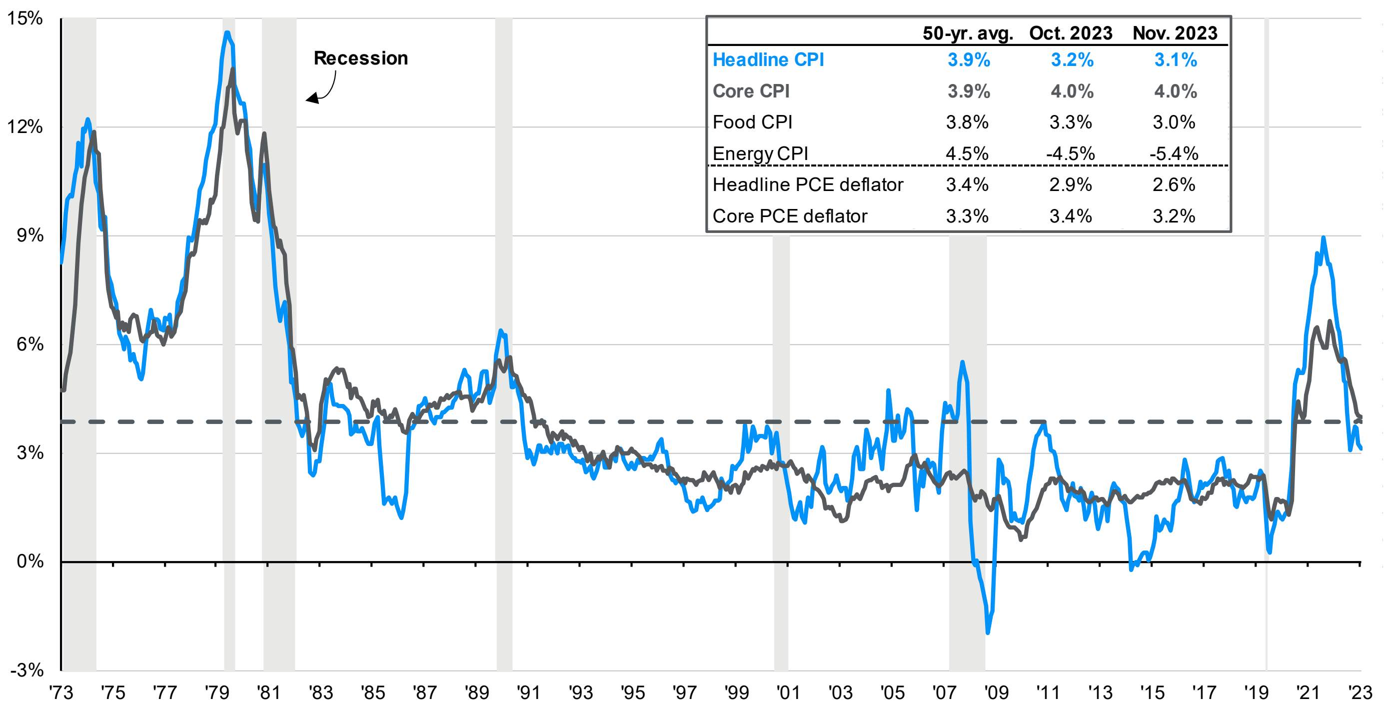
After adjusting for inflation, equities have gained approximately 7% per year over 30 years



After 11 Federal Reserve rate increases inflation is moderating, though still above pre-pandemic levels

CPI and core CPI

% change vs. prior year, seasonally adjusted



	50-yr. avg.	Oct. 2023	Nov. 2023
Headline CPI	3.9%	3.2%	3.1%
Core CPI	3.9%	4.0%	4.0%
Food CPI	3.8%	3.3%	3.0%
Energy CPI	4.5%	-4.5%	-5.4%
Headline PCE deflator	3.4%	2.9%	2.6%
Core PCE deflator	3.3%	3.4%	3.2%

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While nominal yields have increased over the past two years, real yields are still negative